WASHINGTON STATE
OFFICE OF THE INSURANCE COMMISSIONER

FINANCIAL EXAMINATION
OF
PHYSICIANS INSURANCE A MUTUAL COMPANY
SEATTLE
NAIC CODE 40738
EXAMINATION AS OF DECEMBER 31, 2001

Participating States:
Washington

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of PHYSICIANS INSURANCE A MUTUAL COMPANY of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 2001.

Patrick H. McNaughton, Chief Examiner

PHYSICIANS INSURANCE A MUTUAL COMPANY

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SALUTATION

Seattle, Washington
June 3, 2004

The Honorable Kevin McCarty
Director of Insurance Regulation
Florida Department of Financial Services
Chair, NAIC Financial Condition (E) Committee
200 E. Gaines Street, Room 101
Tallahassee, FL 32399-0301

The Honorable John Morrison
Commissioner, Montana Department of Insurance
Secretary, Western Zone
840 Helena Avenue
Helena, MT 59601

The Honorable Mike Kreidler
Commissioner, Washington State Office of the Insurance Commissioner (OIC)
PO Box 40255
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutes of the state of Washington, Chapter 48.03 Revised Code of Washington, an Association Examination has been made of the corporate affairs and financial records of

PHYSICIANS INSURANCE A MUTUAL COMPANY
of
Seattle, Washington

hereinafter referred to as the "Company", "PI" or "Physicians Insurance", at its home office located at 1730 Minor Avenue, Suite 1800, Seattle, Washington 98101. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 2001.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 1995. The current examination conducted by insurance examiners from the state of Washington covered the period from January 1, 1996 through December 31, 2001. Additional examination procedures and testing were performed based upon subsequent events through April 30, 2003. The examination was conducted in accordance with the laws and regulations of the state of Washington contained in Title 48 of the Revised Code of Washington (RCW) and Title 284 of the Washington Administrative Code (WAC) and the examination procedures recommended by the National Association of Insurance Commissioners (NAIC) found in the NAIC Financial Condition Examiners Handbook.

Corporate records and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. The Company's certified public accountant's work papers were reviewed and utilized, where possible, to support efficiency in the examination.

INSTRUCTIONS

Pursuant to the findings and conclusions of the examiners and actuary, in accordance with sound actuarial principles, Title 48 RCW, Title 284 WAC and the NAIC Accounting Practices and Procedures Manual (APPM) for Property and Casualty Insurance Companies, the Company is hereby instructed to comply with the following:

1. Adhere to NAIC Annual Statement Instructions and the NAIC Accounting Practices and Procedures Manuals

The Master Custody Agreement does not contain a provision requiring "...the custodian to notify the Insurance Commissioner within three business days of termination or withdrawal of 100% of the account assets," pursuant to the guidelines in the NAIC Financial Examiners Handbook, Part 1, IV.H.2.f, Custodial Safekeeping Agreements.

Additionally, the Master Custody Agreement does not contain a provision requiring "...the custodian to secure and maintain insurance protection in an adequate amount pursuant to the guidelines in the NAIC Financial Condition Examiners Handbook, Part 1, IV.H.2.k, Custodial Safekeeping Agreements."

The Company is instructed comply with WAC 284-07-050(2) which requires adherence to the appropriate Annual Statement Instructions and the APPM promulgated by the NAIC for the completion of the annual statement. This includes the 2001 NAIC Financial Condition Examiners Handbook.

2. Errors In Annual Statement

The corporate bylaws were amended four times during the years 2000 and 2001. The General Interrogatory disclosure in the Company's Annual Statement for those two years was answered incorrectly as "No changes were made".

The Company is instructed to comply with RCW 48.05.250 which requires the Company to file with the Insurance Commissioner a true annual statement of its financial condition, transactions, and affairs.

3. Written Authorizations

The Company currently retains Ballantyne, McKean & Sullivan, Limited (BMS) and Willis as its reinsurance broker. The Company could not provide the written authorization between itself and the reinsurance intermediary-broker, BMS and Willis. (Written authorization was obtained during the course of the examination.)

The Company is instructed to comply with RCW 48.94.015 and obtain a written authorization, specifying the responsibilities of each party.

4. Prepaid Expenses

Prepaid expenses in the amount of $169,000 were included as Admitted Assets in the 2001 Annual Statement. RCW 48.12.020(2) states that prepaid expenses shall not be allowed as assets in determining the financial condition of an insurer. Prepaid expenses do not meet the definition of admitted assets pursuant to SSAP No. 4 as written in the NAIC APPM.

The Company is instructed to comply with RCW 48.12.020(2) and not treat prepaid expenses as allowable assets; to comply with WAC 284-07-050(2) which requires adherence to the appropriate Annual Statement Instructions and the APPM promulgated by the NAIC for the completion of the annual statement. This includes the 2001 NAIC Financial Condition Examiners Handbook; and to comply with RCW 48.05.250 which requires the Company to file with the Insurance Commissioner a true annual statement of its financial condition, transactions, and affairs. No examination adjustment has been made because the amount is below examination planning materiality.

5. Abandoned Property

The Outstanding Check List revealed a number of checks that had issue dates of more than 5 years ago. There were 45 checks dated 1996 and prior in an aggregate amount of $29,931.05. The Company has not filed any abandoned property reports with the state of Washington during the period of examination.

RCW 63.29.050 defines outstanding checks of more than 5 years as abandoned property. RCW 63.29.170 requires that abandoned property be reported to the state of Washington. RCW 63.29.190 requires payment of those amounts to the state of Washington.

The Company is instructed to comply with RCW 63.29.170 and report abandoned property to the state of Washington pursuant to the definition of abandoned property as stated in RCW 63.29.050 and to comply with RCW 63.29.190 and make payments of the abandoned property amounts to the state of Washington.

COMMENTS AND RECOMMENDATIONS

Pursuant to the findings and conclusions of the examiners:

1. Conflict of Interest Disclosures

The Company's legal counsel performs the review of the annual conflict of interest disclosure statements completed by board of director members, company officers and others in key management positions and reports any potential conflicts to the Board of Directors (BOD). The BOD meeting minutes do not contain any acknowledgment that the conflict of interest statements have been completed, reviewed or that any potential conflicts were reported to the BOD.

It is recommended that the BOD include an acknowledgement in its meeting minutes that the conflict of interest statements have been completed by all appropriate persons and potential conflicts of interest were reported to the BOD.

2. Use of Company Legal vs. Registered Trademark name

The Directors and Officers Liability Policy Including Employment Practices Liability Coverage is written in the name of "Physicians Insurance" as the parent company. This name is a registered trademark and is often used synonymously with the parent's official name, "Physicians Insurance A Mutual Company".

It is recommended that the Company use the official registered name of the parent and affiliates whenever used in any legal documents such as insurance contracts.

HISTORY

The Washington State Medical Association (WSMA) sponsored the organization of Washington Physicians Insurance Exchange (WSPIE or the Exchange) on December 15, 1981 as a reciprocal insurance exchange under Chapter 48.10 RCW. The original Company was an unincorporated aggregation of subscribers operating individually and collectively through its attorney in fact, Washington State Physicians Insurance Association (WSPIA), to provide reciprocal insurance among them.

The name was changed to Physicians Insurance Exchange (PIE) on March 26, 1993. WSPIE or PIE operated in this manner until conversion to a mutual insurer in 1999.

At a special meeting of the Subscribers Council of Physicians Insurance Exchange on May 19, 1999, the subscribers affirmatively approved the Plan of Conversion (plan), new Articles of Incorporation and the Bylaws, and elected the initial Board of Directors.

Physicians Insurance A Mutual Company a Washington corporation converted effective July 1, 1999 to a mutual insurance company under Chapter 48.09 RCW by ORDER APPROVING CONVERSION (No. G 99-20) issued on July 12, 1999, by the Washington State Office of Insurance Commissioner (OIC). The Company is commonly called by its registered trademark name of Physicians Insurance (PI).

Pursuant to Chapter 48.10 RCW, the Insurance Commissioner had jurisdiction over the Plan of Conversion. All parts of the plan and all conditions precedent to the implementation of the conversion set forth in the plan were satisfied and adopted by vote of the subscribers. The plan was not inequitable to subscribers. The surplus requirements of RCW 48.09.270 for Physicians Insurance A Mutual Company were met. The Certificate of Authority was amended by the Insurance Commissioner to Physicians Insurance A Mutual Company.

Capitalization: The Company is incorporated as a mutual insurance company that is owned by and operated in the interest of its members pursuant to RCW 48.09.110 and 120. As a mutual insurer, there is no authorized or issued capital stock. RCW 48.09.100 requires a domestic mutual insurer to maintain surplus funds that represent the excess of its assets over its liabilities in an amount not less than that stated in RCW 48.05.340 for the lines of business that it is authorized to transact. The Company is well capitalized for the lines of business it transacts.

Dividends to Policyholders: Dividends to Policyholders for a mutual insurer are regulated by RCW 48.09.300. The Company had sufficient earnings and earned surplus in the prior years to allow payment of a cash dividend. Dividends were declared for the years 1996, 1997, 1998, and 1999, based upon the earned income portion of accumulated surplus. The maximum amount of dividends which can be paid by state of Washington domestic insurance companies to policyholders without prior approval of the Insurance Commissioner is subject to restrictions relating to statutory surplus. Prior approval was not required for the dividends declared. The BOD approved all dividend declarations.

MANAGEMENT AND CONTROL

Board of Directors: The original bylaws of the re-organized mutual company vested control of the Company in a BOD consisting of nineteen members. Positions 1 through 13 are physician policyholders, positions 14 through 17 are non-physicians, and positions 18 and 19 are nominated by the Washington State Medical Association. Board members are elected at the annual policyholders' meeting for a three-year term and no person may serve on the BOD longer than nine years in a lifetime. The following 18 persons were BOD members as of December 31, 2001:

Name and Address	Principal Business Affiliation	BOD Member Since
Robert C. Jeffers, MD Chairman BOD	Medical Doctor	1993
Thomas J. Curry	Executive Director, WSMA	1994
William E. Danke, MD	Medical Doctor	1996
Patrick M. Fahey	Chairman & CEO Pacific Northwest Bank	1990*
Martin L. Greene, MD	Medical Doctor	1995
Lon M. Hatfield, MD	Medical Doctor	1994
Peter W. Bigelow		1999
Patricia L. Borman, MD	Medical Doctor	1999
Elizabeth A. Cherry, JD	University of Washington Director of Risk Management	1999
Stewart M. Cogan, JD	Arbitrator Mediator	1999
Sanford Levy, MD	Medical Doctor	1999
Peter K. Marsh, MD	Medical Doctor	1999
Gene N. Peterson, MD, PHD	Medical Doctor/PHD	1999
James W. Pritchett M.D.	Medical Doctor	1999
Richard W. Seaman, MD Vice Chairman BOD	Medical Doctor	1994
Cheryl S. Wright-Wilson, MD	Medical Doctor	1999
Kazimer B. Skubi, MD	Medical Doctor	1999
Gary E. Cantlon, MD	Medical Doctor	2000

* (Pursuant to new Articles of Incorporation and new Bylaws, Articles 3.3 and 3.4, the reorganization and conversion to a mutual company during 1999, allowed Patrick M. Fahey two additional three year terms.)

Officers: Officers are elected at the annual BOD meeting for a one-year term. Officers as of December 31, 2001 were:

Name	Position held
Thomas L. Myers	President and Chief Executive Officer
Richard E. Brown	Senior Vice President/Chief Financial Officer & Treasurer
Thomas A. Fine	Senior Vice President/Underwriting & Marketing
Bruce W. Schafer	Senior Vice President/Claims & Risk Management
Patricia C. Berger	Vice President/Litigation Management
Paul A. Buckner	Vice President/Eastern Regional Office
James J. J. Corbin	Vice President/Marketing
Terry B. Evans	Vice President/Information Services
John R. Karlen	Vice President/Products & Services Development
Thomas E. Kirchmeier	Vice President/Risk Management/Education
Judith J. Mix	Vice President/Corporate Secretary
Gary L. Morse	Vice President/General Counsel
Robert J. Nickles	Vice President/Oregon Regional Office
Vince A. Rota	Vice President/Hospitals
Pamela B. Tinsley	Vice President/Underwriting
Kristin L. Kenny	Associate Vice President/Controller

Committees: The Standing committees of the Board are: Executive Committee; Audit Committee; Nominating Committee; Investment Committee; Underwriting/Marketing Committee; Claims Committee; and Risk Management/Education Committee.

Conflict of Interest and Confidentiality Policy: The Company has a conflict of interest agreement and policy that requires the annual completion of a Conflict of Interest Agreement by officers, directors, and key employees. All are required to disclose to the corporate counsel relevant outside interests, memberships, associations, and affiliations. All appropriate persons have complied with this policy. Potential conflict of interest issues and confidential and proprietary information are provided to the BOD on a "need to know" basis as determined by the corporate counsel. There were no noted discussions in the BOD meeting minutes regarding the conflict of interest policy. It is recommended that the corporate counsel make an annual report to the BOD that the process has been completed and discuss relevant disclosures. (See "COMMENTS AND RECOMMENDATIONS" No. 1, Pg. 3.)

The examiners' review of the conflict of interest statement and confidentiality policy, and the Company's review process disclosed that the Company makes a concerted effort to protect the confidentiality of the Company strategy, all records, data and any other information of a private or sensitive nature and no conflicts have been disclosed.

CORPORATE RECORDS

The initial articles of incorporation after re-organization to a mutual company were adopted by the BOD and filed with the OIC and the Secretary of State of the state of Washington and became effective July 1, 1999. No amendments have been made to the Articles of Incorporation since their adoption.

The corporate bylaws for the re-organized mutual company were also effective July 1, 1999. The bylaws have been amended four times since re-organization. The definitions of committees provided in the bylaws in Articles 3.9.5 Underwriting/Marketing Committee, 3.9.6 Claims Committee, and 3.9.7 Risk Management/Education Committee, were amended on February 23, 2000. Article 2.5 Quorum was amended April 24, 2000 defining a quorum as 20% of all members qualified to vote instead of 50%. Article 3.1 Number was amended April 30, 2001 to allow for a gradual reduction in the number of directors from 19 to 15 members beginning in the year 2001. The definition of Audit Committee provided in Article 3.9.2 was amended October 27, 2001, and the name was changed to Finance and Audit Committee. The changes to the bylaws were not disclosed in the annual statement General Interrogatories for either of the two years. (See "INSTRUCTIONS" No. 2, Pg. 2.)

The BOD was active throughout the examination period. BOD meetings and committee meetings were well attended and the minutes were in sufficient detail and substance to demonstrate that the BOD members were actively involved in the administration of the affairs of the Company. All meetings were documented in written form, noting items of discussion, and specific actions taken.

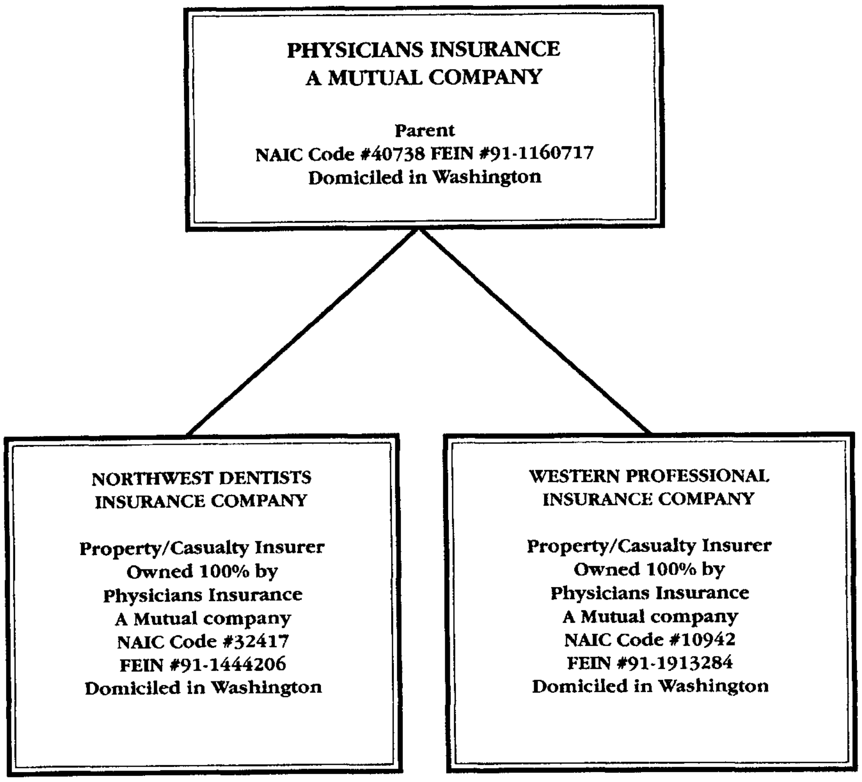
AFFILIATED INSURANCE COMPANIES

The following companies are all insurer members of a holding company group and have filed a registration statement under the provisions of Washington's Insurer Holding Company Act pursuant to Chapter 48.31B RCW. Annual Statement Instructions for Schedule Y, Part 2, do not require the disclosure of non-insurer affiliates, unless it is the parent company, or the transactions are equal to or greater than one-half of one percent of the total assets of the largest affiliated insurer. This reporting criteria is reflected in our examination report.

Northwest Dentists Insurance Company (NORDIC) is a Washington corporation organized as a stock insurance company on May 10, 1989 by Physicians Insurance Exchange as its wholly owned subsidiary. The Company was organized to provide comprehensive professional liability insurance to dentists practicing principally in the state of Washington.

Western Professional Insurance Company (WPIC) is a wholly owned subsidiary of Physicians Insurance A Mutual Company. WPIC was organized in 1998 to provide comprehensive professional liability insurance to hospitals for Washington, Oregon, and Montana risks. All business underwritten by WPIC is fully ceded to Physicians Insurance, except premiums related to the expense loading on facultative reinsurance.

Organization Chart: The following organization chart depicts the relationship of the insurer affiliates under the holding company system as of December 31, 2001.



The Company is a participant in several inter-company agreements. As a member of an insurance company holding system, these have been filed pursuant to RCW 48.31B.025 with the OIC. As of December 31, 2001, the Company was party to the following agreements:

Management Agreement: The Company entered into a Management Agreement with Washington State Physicians Insurance Association (WSPIA) on June 23, 1998, wherein WSPIA agreed to serve as the general manager for the insurance issued by the Company. The agreement outlines the duties and responsibilities of each party and reimbursement of fees for the services performed. These duties and responsibilities were assumed by Physicians Insurance A Mutual Company.

Tax Allocation Agreement: The Company files a consolidated federal income tax return with its affiliated companies, Northwest Dentists Insurance Company, Western Professional Insurance Company, Association Insurance Services, Inc., and PHYSIS Corporation. The method of allocation among the affiliated companies is subject to a written agreement approved by the Board of Directors. The agreement calls for allocation of taxes based upon separate return calculations with current credit for net losses. All amounts payable or receivable will be made by way of journal entries to inter-company accounts established for this purpose. Inter-company tax balances are settled annually in the first quarter.

On a consolidated basis, there was no taxable income in 2001.

FIDELITY BOND AND OTHER INSURANCE

The Company is a named insured on a Financial Institution Fidelity Bond. An aggregate loss limit of coverage in the amount of $2,500,000 is provided for all of the affiliated companies insured and a single loss deductible is $50,000. The minimum amount recommended by the NAIC for the three insurance companies is $900,000 to $1,000,000. The calculation indicates that the aggregate amount of coverage is adequate to cover the exposure risk of the Company and its affiliates.

The Company is also provided protection against certain property and liability losses as a named insured on several other policies.

Policies in effect at December 31, 2001 provided the following coverages:

- Directors and Officers Liability Insurance including Employment Practices Liability Coverage
- Commercial Property
- Electronic Data Processing
- Commercial General Liability
- Commercial Automobile
- Commercial Umbrella Liability Policy

The Company does not have any "Errors and Omissions" coverage. The Company has chosen to be self insured for this hazard and risk.

The Directors and Officers Liability and Employment Practices Liability policy is written in the name of "Physicians Insurance" as the parent company. This name is a registered trademark and is often used synonymously with the parent's official name, "Physicians Insurance A Mutual Company". (See "COMMENTS AND RECOMMENDATIONS" No. 2, Pg. 3.)

The review of the Company's insurance policies indicated that adequate insurance coverage has been purchased and is in force covering the hazards to which the Company is exposed as of the examination date.

EMPLOYEES' BENEFIT PLANS

Physicians Insurance A Mutual Company is the employer for all affiliated companies. Salaries and benefits are allocated to the three affiliated insurance companies based upon management and allocation agreements: 75% to PI, 15% to WPIC and 10% to NORDIC.

Employees who are twenty-one years old and have completed one month of service are eligible to participate in two defined contribution plans. For 401(k) participants, employees may make pre-tax contributions up to 8% of their base compensation per year, to which the Company will match these contributions up to 6.6% of the employees' base compensation. The Company currently contributes 10% of the employees' base compensation to the Money Purchase Plan and employees may make voluntary after-tax contributions to the plan.

Vesting requirements are five years of service for 100% of the employer's contribution and immediate vesting for 100% of the employees' contribution.

The Company also provides other plans and benefits to its employees such as Medical and Dental Insurance, Life Insurance and Accidental Death and Dismemberment Insurance, Long-

Term Disability, Travel Accident Insurance, Employee Assistance Program (EAP), Workers' Compensation Insurance, Education and Course Reimbursement. The Company also offers the usual options for time off from work including vacation, holidays, sick leave and other leaves of absence.

TERRITORY AND PLAN OF OPERATION

Physicians Insurance is authorized to transact multiple property and casualty lines of business in Alaska, Idaho, Montana, Oregon, Utah, Washington, and Wyoming. The Company specializes in writing medical malpractice insurance for physicians and surgeons licensed in Washington. The Company has a dominant market position in Washington which is a limiting factor in its growth opportunities. During 1995, the Company began to increase its authority and presence in Alaska, Idaho, Montana, and Oregon. Currently, these states account for less than five percent of the total premium volume. The Company has been inactive in Utah and Wyoming.

GROWTH OF COMPANY

The following are the Company's historical direct writings:

Direct Premiums Written by State (Schedule T – Premiums)

	1997	1998	1999	2000	2001
Washington	$49,847,814	$56,003,913	$48,730,061	$50,246,289	$56,243,402
Oregon	109,906	1,485,071	505,538	923,751	1,028,681
Montana	861,645	1,313,623	1,027,412	1,296,726	1,792,361
Idaho	39,068	47,796	78,409	138,214	185,986
Alaska	209,286	184,037	169,940	131,637	171,797
	$51,067,719	$59,034,440	$50,511,360	$52,736,617	$59,422,227

Direct Premiums Written by Line of Business

	1997	1998	1999	2000	2001
Commercial Multiple Peril	$318,845	$347,478	($2,264)	$0	$0
Medical Malpractice	49,622,125	52,501,727	50,739,663	51,871,556	59,323,519
Other Liability	188,890	415,470	79,999	94,402	98,708
Provider Excess Liability	937,859	5,769,765	(306,038)	770,659	0
	$51,067,719	$59,034,440	$50,511,360	$52,736,617	$59,422,227

The Company is appropriately licensed for the lines of business it writes.

ACTUARIAL REVIEW

The reserves were reviewed by the casualty actuarial staff employed by the OIC. The Commissioner's actuarial staff was able to create loss and loss adjustment expense development triangles by policy year, net of reinsurance, as of December 31, 2002, from data provided by Company personnel. (In other words, the data included 12 months of development subsequent to the examination period.) Company personnel provided additional information by electronic mail, by telephone, and in a face-to-face meeting. Actuarial staff also reviewed an actuarial report prepared by the Company's consulting actuarial firm, Tillinghast-Towers Perrin.

Based on their analysis of data through December 31, 2002, the Commissioner's actuarial staff concluded that the Company's booked reserves for unpaid losses and unpaid loss adjustment expenses as of December 31, 2001, are within a reasonable range. Therefore, the reserves are accepted as shown in the 2001 Annual Statement.

REINSURANCE PROGRAM

The Company has the following reinsurance in effect as of December 31, 2001:

Reinsurance Ceded:

The Company has entered into reinsurance agreements with authorized reinsurers for the following protection:

Type of Contract	Retention Level	Reinsurance Limits
First Excess of Loss	$1,000,000	$2,000,000 Ultimate net loss; Each loss.
Combined Risk and Contingent Excess of Loss	$3,000,000 $2,000,000	$3,000,000 Ultimate net loss: Each loss. Each insured.
Second Contingent Excess of Loss	$6,000,000	$9,000,000 Ultimate net loss; Each loss.
Catastrophe "Awards Made" Excess of Loss	$15,000,000	$25,000,000 Ultimate net loss; Each loss.
Non-Standard Physicians, 75% Quota Share	25% of $3,000,000 in Losses	75% of $3,000,000 Aggregate/ $1,000,000 per claim (Except one policy with $2,000,000 per claim and $6,000,000 Aggregate limits).
Business Owner's Policy, 70% Quota Share	$30% of Each Policy	70% of Coverage levels.
Directors' & Officers' Liability Quota Share:		
Clinics	$10,000 per claim	$1,000,000 Any one insured.
Hospitals		$5,000,000 Any one insured.
Legal Expense Reimbursement Quota Share		$100,000 Any one insured group. Individual and aggregate claim limits varying from $40,000 to $125,000, depending on the group size.
Provider Medical Expenses Excess of Loss	50%	Up to $2,000,000 per covered individual per annum, excess of Minimum deductible in the original policy.

The above contracts have the standard insolvency clause wording, required by the Washington Insurance Code, to minimize the Company's risk. The Company does not do business with unauthorized reinsurers. However, there are two unauthorized reinsurers participating in contracts in run off status for which appropriate letters of credit are in place. The provision for unauthorized reinsurance on reinsurance recoverable is $163,000.

INFORMATION SYSTEMS AND ACCOUNTING RECORDS

The management of the Company is sufficiently knowledgeable of EDP issues and provides direction and oversight through its Steering Committee. New systems development, acquisition and maintenance controls have been reviewed to gain assurance that programs and systems are designed, tested, approved and implemented using appropriate controls. Internal controls that are in place provide for the proper separation of duties.

Operations controls and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed: and the controls exercised to maintain data security. Adequate procedures and controls are in place for mainframe and network operations.

CONTINGENT LIABILITIES AND COMMITMENTS

The Company leases office facilities and certain equipment under non-cancelable operating leases through 2004. Annual rental expense under these lease agreements was $751,591 and $715,754 in 2001 and 2000, respectively.

Future minimum commitments under these leases as of December 31, 2001, are as follows:

2002	$ 834,016
2003	914,637
2004	917,415
2005	920,943
2006	924,579
2007	484,752
	$ 4,996,342

SUBSEQUENT EVENTS

The market environment has changed since the examination date. Market share increased during 2002 largely as a result of Washington Casualty Company's exit from the physician medical malpractice market. This has since been tempered somewhat by a moratorium on new business that was declared by management in the fall of 2002. Market share has declined slightly in 2003 as a result of the moratorium.

Significant adverse development of the 1999 and 2000 accident years occurred in 2002. Historically, two years after an accident year, minor redundancies in incurred losses are noted. In 2002, an adverse development of 10% for the 2000 accident year was noted. The Company believes this was due to the increased valuation placed on cases by plaintiffs. Claim investigators, therefore, are reacting by placing higher reserves on files in expectation of higher payouts. Also, the 1999 accident year had a larger than normal amount of reopened claims in 2002 as plaintiffs filed lawsuits on previously inactive cases.

Since the examination date, Thomas A. Fine, Senior Vice President/Underwriting & Marketing and Patricia Claire Berger, Vice President/Litigation Management, retired, and Thomas L. Myers, President and Chief Executive Officer announced his retirement.

FINANCIAL STATEMENTS

The following statements reflect the financial condition of the Company as of December 31, 2001, as determined by this examination:

Balance Sheet
As of December 31, 2001

Comparative Balance Sheet
Years Ended December 31, 2000 and 2001

Statement of Income
As of December 31, 2001

Comparative Statement of Income
Years Ended December 31, 2000 and 2001

Capital and Surplus Account
As of December 31, 2001

Comparative Capital and Surplus Account
Years Ended December 31, 2000 and 2001

PHYSICIANS INSURANCE A MUTUAL COMPANY

BALANCE SHEET

AS OF DECEMBER 31, 2001

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
ASSETS				
Bonds	$206,274,530		$206,274,530	1
Common stocks	21,570,250		21,570,250	2
Cash and short-term investments	12,206,654		12,206,654	3
Agents' balances or uncollected premiums:				
Premiums in course of collection	1,459,830		1,459,830	4
Reinsurance recoverable	1,202,052		1,202,052	
Federal income tax recoverable	4,528,460		4,528,460	5
Guaranty funds receivable or on deposit	7,340		7,340	
Electronic data processing equipment	376,956		376,956	
Interest and dividend income due and accrued	2,998,803		2,998,803	
Receivable from parent, subsidiaries and affiliates	742,438		742,438	6
Aggregate write-ins for other than invested assets	208,276		208,276	7
Total assets	$251,575,589	$0	$251,575,589	
LIABILITIES				
Losses	$127,434,676		$127,434,676	8
Reinsurance payable on paid losses	696,170		696,170	
Loss adjustment expenses	33,176,056		33,176,056	8
Other expenses (excluding taxes, licenses & fees)	3,040,550		3,040,550	
Taxes, licenses & fees (excl. fed. inc. tax)	195,597		195,597	
Unearned premiums	8,044,232		8,044,232	9
Amounts withheld by company for others	519,742		519,742	
Provision for reinsurance	163,000		163,000	
Aggregate write-ins for liabilities	8,263,996		8,263,996	10
Total liabilities	181,534,019	0	181,534,019	
SURPLUS AND OTHER FUNDS				
Unassigned funds (surplus)	70,041,570		70,041,570	
Surplus as regards policyholders	70,041,570	0	70,041,570	
Total liabilities, surplus and other funds	$251,575,589	$0	$251,575,589	

PHYSICIANS INSURANCE A MUTUAL COMPANY

COMPARATIVE BALANCE SHEET

AS OF DECEMBER 31,

	2001	2000
ASSETS		
Bonds	$206,274,530	$203,683,076
Common stocks	21,570,250	20,742,299
Cash and short-term investments	12,206,654	4,884,264
Agents' balances or uncollected premiums:		
Premiums in course of collection	1,459,830	1,952,585
Reinsurance recoverable	1,202,052	2,273,586
Federal income tax recoverable	4,528,460	13,971
Guaranty funds receivable or on deposit	7,340	7,340
Electronic data processing equipment	376,956	455,583
Interest and dividend income due and accrued	2,998,803	2,961,048
Receivable from parent, subsidiaries and affiliates	742,438	707,363
Aggregate write-ins for other than invested assets	208,276	8,670,337
Total assets	$251,575,589	$246,351,452
LIABILITIES		
Losses	$127,434,676	$128,541,426
Reinsurance payable on paid losses	696,170	518,412
Loss adjustment expenses	33,176,056	32,230,621
Other expenses (excluding taxes, licenses & fees)	3,040,550	3,119,948
Taxes, licenses & fees (excl. fed. inc. tax)	195,597	104,909
Unearned premiums	8,044,232	10,564,108
Amounts withheld by company for others	519,742	500,819
Provision for reinsurance	163,000	455,000
Aggregate write-ins for liabilities	8,263,996	6,342,663
Total liabilities	181,534,019	182,377,906
SURPLUS AND OTHER FUNDS		
Unassigned funds (surplus)	70,041,570	63,973,546
Surplus as regards policyholders	70,041,570	63,973,546
Total liabilities, surplus and other funds	$251,575,589	$246,351,452

PHYSICIANS INSURANCE A MUTUAL COMPANY

STATEMENT OF INCOME

YEAR ENDED DECEMBER 31, 2001

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION
UNDERWRITING INCOME			
Premiums earned	$57,136,567	$0	$57,136,567
DEDUCTIONS:			
Losses incurred	43,158,928		43,158,928
Loss expenses incurred	19,628,608		19,628,608
Other underwriting expenses incurred	7,251,792		7,251,792
Total underwriting deductions	70,039,328	0	70,039,328
Net underwriting gain or (loss)	(12,902,761)	0	(12,902,761)
INVESTMENT INCOME			
Net investment income earned	13,730,436	0	13,730,436
Net realized capital gains or (losses)	1,208,690		1,208,690
Net investment income gain or (loss)	14,939,126	0	14,939,126
OTHER INCOME			
Net gain or loss from agents' or premium balances charged off	(25,621)		(25,621)
Finance and service charges not included in premiums	510,909		510,909
Miscellaneous income	(1,166,453)		(1,166,453)
Total other income	(681,165)	0	(681,165)
Net income before dividends to policyholders and before federal and foreign income taxes	1,355,200	0	1,355,200
Dividends to policyholders	(7,645)		(7,645)
Net income before federal and foreign income taxes	1,362,845	0	1,362,845
Federal and foreign income taxes incurred	(194,668)		(194,668)
Net income	$1,557,513	$0	$1,557,513

PHYSICIANS INSURANCE A MUTUAL COMPANY
COMPARATIVE STATEMENT OF INCOME
FOR THE YEARS ENDED DECEMBER 31,

	2001	2000
UNDERWRITING INCOME		
Premiums earned	$57,136,567	$56,361,411
DEDUCTIONS:		
Losses incurred	43,158,928	43,241,069
Loss expenses incurred	19,628,608	18,448,400
Other underwriting expenses incurred	7,251,792	6,661,308
Total underwriting deductions	70,039,328	68,350,777
Net underwriting gain or (loss)	(12,902,761)	(11,989,366)
INVESTMENT INCOME		
Net investment income earned	13,730,436	12,796,208
Net realized capital gains or (losses)	1,208,690	752,507
Net investment income gain or (loss)	14,939,126	13,548,715
OTHER INCOME		
Net gain or loss from agents' or premium balances charged off	(25,621)	3,910
Finance and service charges not included in premiums	510,909	460,304
Miscellaneous income	(1,166,453)	13,436
Total other income	(681,165)	477,650
Net income before dividends to policyholders and before federal and foreign income taxes	1,355,200	2,036,999
Dividends to policyholders	(7,645)	(28,842)
Net income before federal and foreign income taxes	1,362,845	2,065,841
Federal and foreign income taxes incurred	(194,668)	18,000
Net income	$1,557,513	$2,047,841

PHYSICIANS INSURANCE A MUTUAL COMPANY

CAPITAL AND SURPLUS ACCOUNT
AS OF DECEMBER 31, 2001

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION
Surplus as regards policyholders, December 31, previous year	$63,973,546	$0	$63,973,546
GAINS AND (LOSSES) IN SURPLUS			
Net income	1,557,513		1,557,513
Net unrealized capital gains or (losses)	(96,100)		(96,100)
Change in non-admitted assets	36,148		36,148
Change in provision for reinsurance	292,000		292,000
Cumulative effect of change in accounting principles	4,278,463		4,278,463
Changes in surplus	6,068,024	0	6,068,024
Surplus as regards policyholders, December 31, current year	$70,041,570	$0	$70,041,570

COMPARATIVE CAPITAL AND SURPLUS ACCOUNT
AS OF DECEMBER 31,

	2001	2000	1999	1998	1997
Surplus as regards policyholders, December 31, previous year	$63,973,546	$63,846,681	$63,190,683	$59,567,748	$52,077,496
GAINS AND (LOSSES) IN SURPLUS					
Net income	1,557,513	2,047,841	620,706	1,618,503	4,880,176
Net unrealized capital gains or (losses)	(96,100)	(1,446,506)	(530,266)	1,994,240	2,742,152
Change in non-admitted assets	36,148	(330,470)	124,558	(51,808)	(233,076)
Change in provision for reinsurance	292,000	(144,000)	441,000	62,000	101,000
Cumulative effect of change in accounting principles	4,278,463				
Capital changes					
Surplus adjustments					
Changes in surplus	6,068,024	126,865	655,998	3,622,935	7,490,252
Surplus as regards policyholders, December 31, current year	$70,041,570	$63,973,546	$63,846,681	$63,190,683	$59,567,748

NOTES AND COMMENTS TO FINANCIAL STATEMENTS

1. **BONDS** in the amount of $206.3 million represent 82% of total assets; an increase of 5.2% over the year 2000. The Company has taken a more conservative investment strategy by shifting more assets from common stocks to bonds. The investment in higher yielding industrial bonds has increased while investment in government bonds has decreased. Bonds are stated at amortized cost, secured, and not in default as to principle and interest. The Company accrues discounts and amortizes premiums using the scientific method.

2. **COMMON STOCKS** in the amount of $21.6 million represent 8.6% of total assets, a decrease of 5.7% over the year 2000. The approximate value of common stock investments other than in subsidiaries is $4.33 million, representing about 1.72% of total assets. All common stocks are valued at market pursuant to RCW 48.12.180 except for the common stock of affiliates which are valued using the equity method. Market value is established by using the published market rates of the Securities Valuation Office of the NAIC.

3. **CASH AND SHORT TERM INVESTMENTS** are $12.2 million and 4.9% of total assets. Short term investments with maturity dates of one year or less, consisted of two NAIC Class 1 money market funds valued at $4.3 million and one United States Treasury Bill valued at $7 million. Cash items consisted primarily of demand deposits with maturities of 90 days or less.

4. **AGENTS BALANCES OR UNCOLLECTED PREMIUMS** are a net $1.46 million and .58% of total assets. There are $93,000 non-admitted overdue balances.

5. **FEDERAL INCOME TAX RECOVERABLE** is $4.5 million. As of December 31, 2001, the Company had $2.5 million of operating loss carry-forwards originating from the years 1999 through 2001. The Company files a consolidated return with its affiliated companies. The method of allocation among the companies is subject to written agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Inter-company balances are settled annually in the first quarter of the following year.

6. **RECEIVABLE FROM PARENT, SUBSIDIARIES AND AFFILIATES** is a net receivable from affiliated companies in the amount of $742,000. The Company owns 100% of the outstanding stock of each of its subsidiaries and performs substantially all service to its subsidiaries and is reimbursed under management agreements. Costs are shared based on gross premiums written.

7. **AGGREGATE WRITE-INS FOR OTHER THAN INVESTED ASSETS** is $208,000 of which $169,900 is prepaid expenses. Prepaid expenses are non-admitted assets. No examination adjustment has been made because the amount is below examination planning materiality. (See "INSTRUCTIONS" No. 4, Pg. 2.)

8. **LOSSES AND LOSS ADJUSTMENT EXPENSES** respectively are reported as $127,434,676 or 50.655% and $33,176,056 or 13.187% of total assets as of December 31, 2001.

9. **UNEARNED PREMIUMS** are $8 million or 3.2% of total assets. Generally, most policies are written with a January 1 effective date and would be fully earned at year end. Unearned premiums increased dramatically due to changes adopted to conform to Codification which was reported as an adjustment to unassigned surplus in 2001. The cumulative effect of these accounting changes amounts to $4,278,462. Additionally, the Company reclassified its reserve for free-tail coverage for loss reserve to unearned premium. There is no income effect as a result of the reclassification. The impact of the change reduces prior year loss reserves by $7.3 million and increases prior year unearned premium by $7.3 million.

10. **AGGREGATE WRITE-INS FOR LIABILITIES** are $8.26 million or 30.292% of total assets. The total amount represents premiums received in advance. Nearly all of PI's policies are annual and most have a common inception date of January 1st. Policies issued mid-year are partial year policies expiring on December 31st to maintain the common inception date for the book of business. Billing occurs prior to year end and payments are generally received prior to the January 1st due date. The premium accounting system tracks premiums received in advance and nets them against premiums receivable. The Company makes a reclassification entry from premiums receivable to aggregate write-ins in order to not distort actual premiums receivable.

ACKNOWLEDGMENT

Acknowledgement is hereby made of the cooperation extended to the examiners by the officers and employees of Physicians Insurance A Mutual Company during the course of this examination.

In addition to the undersigned, Larry A. Omdal, Examiner in Charge, Constantine Arustamian, CPA, Insurance Examiner, Friday Enoye, Insurance Examiner, Juanita Turley, Insurance Examiner, John Gaynard, AFE, CPA, CPCU, Insurance Examiner and Reinsurance Specialist, John Jacobson, AFE, Insurance Examiner/Field Supervisor and EDP Specialist, Lee Barclay, FCAS, MAAA, ARM, Senior Actuary and Jim Antush, Actuarial Analyst, all from the OIC, participated in the examination and preparation of this report.

Respectfully submitted,

Michael V. Jordan

Michael V. Jordan, CPA, CFE, MHP
Assistant Chief Examiner
State of Washington

AFFIDAVIT

State of Washington)
) ss
County of King)

Michael V. Jordan, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

He attests that the examination of Physicians Insurance A Mutual Company was performed in a manner consistent with the standards and procedures required or prescribed by the Washington State Office of the Insurance Commissioner and the National Association of Insurance Commissioners (NAIC)

Michael V. Jordan

Michael V. Jordan, CPA, CFE, MHP
Assistant Chief Examiner
State of Washington

Subscribed and sworn to before me on this 3rd day of June, 2004.

Colleen Jansen

Notary Public in and for the
State of Washington, residing at Seattle.

COLLEEN JANSEN
NOTARY PUBLIC
5-17-08
STATE OF WASHINGTON